

CALIFORNIA STATE TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Internal Equity Policies

ITEM NUMBER: 8

ATTACHMENT(S): 1

ACTION: X

DATE OF MEETING: October 11, 2000

INFORMATION: _____

PRESENTER(S): Steven Tong

Executive Summary

In July 2000, the Investment Committee adopted the annual business plan for Internal Equities. As stated in the plan, the primary responsibilities of Internal Equities staff (Staff) are to manage the internal S&P 500 Indexed portfolio and the Cash Equitization program.

The current policies for the S&P 500 Indexed portfolio were created when the portfolio was \$1 billion in size. The S&P 500 Indexed portfolio began operations on April 1, 1998. Approximately one year after the inception of the portfolio, the Investment Committee approved an increase in the size of the internally managed S&P 500 Indexed portfolio to 50% of CalSTRS' overall passive S&P 500 allocation. As of June 30, 2000, the portfolio market value was \$15.1 billion.

In January 1999, the Investment Committee approved the policies for the Cash Equitization program. The Cash Equitization program helps to keep the domestic equity exposure in line with the adopted strategic asset allocation target by using the S&P 500 Index futures to equitize cash. Functionally, futures are purchased to overlay cash, then to maintain equity exposure. Staff must "roll" these futures position forward by selling the expiring futures contracts and buying the deferred future contracts prior to each quarterly expiry. As of June 30, 2000, the program's market value was approximately \$144 million, which represented approximately 60% of the average cash balance. Going forward, the goal of the program is to equitize a larger portion of cash earmarked for domestic equities. The operational and performance tracking efficiencies should be improved when a larger portion of cash is equitized.

The increased size of the S&P 500 portfolio has resulted in a significantly larger notional amounts traded in the event of index changes and adjustments. Similarly, the planned expansion of the Cash Equitization program should result in a higher number of futures contracts traded. Hence, a modification to the current Internal Equity policies is needed. Attachment 1 provides the proposed changes to the current Internal Equity policies to increase the trading authority limits of Staff. The policies for the internal programs have been revised to reflect the increase of assets under internal investment management.

The objectives and guidelines for the S&P 500 Indexed portfolio and the Cash Equitization program are expressly stated in written policies (Attachment 1). The policies provide parameters that ensure prudence and care in the execution of the internal management programs, while allowing sufficient flexibility for proper portfolio management, risk control, and opportunistic trading. The policies are static in nature and cannot be changed without the approval of the Investment Committee.

Recommendations

Staff recommends that the Investment Committee revise the policies for the internally managed S&P 500 Indexed portfolio and the Cash Equitization program. Pension Consulting Alliance has reviewed the proposals to and concurs with Staff's recommendations for approval.

California State Teachers' Retirement System Internal Equities Policies

The California State Teachers' Retirement System established a broad-based asset allocation policy, which includes a 38% strategic allocation to domestic equities. At 38% of total assets, domestic equity is the largest asset class in the CalSTRS' portfolio. In 1996, the Investment Committee adopted the Russell 3000 Index as its domestic equity performance benchmark. This benchmark consists of the largest 3,000 U.S.-domiciled companies, weighted by their float-adjusted market capitalization.

The Russell 3000 Index can be divided into two modular components. The large capitalization module is the S&P 500 Index. The Russell Small Cap Completeness Index (formerly Russell Special Small Company Index) represents the medium and small capitalization component. When the two segments are combined in their approximate weight relative to the Russell 3000 Index, the combination should approximate the capitalization, yield, industry sectors, and performance of the Russell 3000 Index.

In 1998, the Investment Committee implemented major structural changes in which 20% of the domestic equity assets is placed in "active" mandates and 80% in "passive" mandates. Active mandates are those investment assignments that, in aggregate, the Investment Committee expects to outperform the asset class benchmark (Russell 3000) over an investment cycle. Passive mandates are those assignments that, in aggregate, should match the investment performance of the Russell 3000. CalSTRS' internal S&P 500 indexed portfolio is a segment of the overall passive component of the domestic equity portfolio.

In October 1998, the Investment Committee approved the concept of cash equitization to be used within the domestic equity class. The primary intent of cash equitization is to create a mechanism for keeping the domestic equity exposure as close as practically possible to the adopted strategic asset allocation policy target.

This document outlines the policies for CalSTRS' internally managed S&P 500 Indexed portfolio and Cash Equitization program.

I. S&P 500 Indexed Portfolio

Policies for the management of the internal S&P 500 Indexed portfolio (Portfolio) are listed below:

1. The domestic equity assets of CalSTRS are to be invested in a prudent manner for the sole benefit of its participants and beneficiaries, in accordance with applicable portions of California State law.

2. The Portfolio's performance objective is to seek to realize a performance of the S&P 500 index, as reported by the master custodian. The deviations between the performance of the Portfolio and the benchmark (tracking error) should be random. The annualized tracking error will be limited to +/- 0.12% (12 basis points). A larger tracking error will be allowed as the result of a deliberate decision to reduce turnover or to control a specified risk contained in the Portfolio.
3. To achieve the stated performance objective, the Portfolio invests in a diversified portfolio of equity securities in the index. The Portfolio will be managed in a passive manner, with risk characteristics closely resembling the S&P 500 Index. When the S&P 500 index is expensive to fully replicate due to temporary circumstances such as transaction costs or market liquidity, an optimized approach with fewer stocks may be used with the approval of the Chief Investment Officer.
4. Security transactions are performed when necessary to approximate the characteristics of the S&P 500 Index and fulfill the performance objective.
5. The value of the internal indexed portfolio will be 50% (minimum allocation of 45% and maximum allocation of 55%) of the total S&P 500 passive mandate.
6. The total holdings of securities in the Portfolio issued by any one U.S. corporation shall be limited to five (5%) percent of the total issued and outstanding shares.
7. The investment securities prohibited by the most recent Investment Resolution will not be purchased or held in the internally managed domestic equity indexed Portfolio. A customized index may be used when companies contained in the S&P 500 Index are prohibited from being held in the Portfolio.
8. S&P 500 Index futures contracts and Standard and Poor's Depository Trust Receipts (SPDRs) may be used for equitizing cash positions.
9. All transactions will be carefully evaluated to determine the expected benefits to the Portfolio. Efficient trading strategies will be utilized in order to minimize market impact and transaction costs. In all transactions, investment personnel shall use best efforts to obtain the most favorable execution available at the time of the trade.
10. Investment personnel will comply with the rules of the Securities Exchange Commission (SEC), exchanges, and other regulatory agencies.
11. Brokers will be selected for their quality of execution, quality and timeliness of the operation area, and creditworthiness. A diversified group of brokers will be used to insure overall quality of trade executions.
12. The Chief Investment Officer has the authority to manage the Portfolio internally and may use other investment personnel for the management of the Portfolio.

13. Net open trade (purchase minus sale) transaction dollar limits will be capped at ~~\$50~~200 million for agency trades. Principal trades will be specifically exempted from the ~~\$50~~200 million open trade limit.

14. The Chief Investment Officer has the authority to trade appropriate securities for the Portfolio and may ~~usedesignate~~ other investment personnel to ~~conduct trading act for him/her with regards to investments for the Portfolio~~. The ~~graduated limitations of daily limits for approval of tradetrading authority for Portfolio transactions~~ are designated below:

Chief Investment Officer	\$1 billion
Director of Internal Equity	\$100 <u>500</u> million
<u>Principal Investment Officer</u>	<u>\$300 million</u>
Investment Officer III	\$50 <u>200</u> million
Investment Officer II	\$20 <u>100</u> million
Investment Officer I	\$10 <u>50</u> million

15. Authorization letters which indicate who may transact business for the Portfolio, including a copy of the most recent Investment Resolution, shall initially be sent to the broker at the time the account is established. Whenever there is a change in authorized personnel, CalSTRS will immediately notify all brokers in writing within twenty four (24) hours.

16. The Chief Investment Officer shall monitor the investment policies and report to the CalSTRS' Board quarterly or as otherwise requested.

Adopted January 7, 1998

Revised _____

II. Cash Equitization Program

Polices for the management of the Cash Equitization program (Program) are listed below.

1. The Program's objective is to substitute a S&P 500 Index return for a cash return within the domestic equity Portfolio.
2. The Program will pursue its investment objective by investing in S&P 500 Index futures contracts, Standard and Poor's Depository Trust Receipts (SPDRs), and/or short-term fixed income securities for the following purposes:
 - Facilitate investment of active domestic equity manager's cash balances;

- Eliminate cash drag resulting from cash flows in the S&P 500 Index portfolios; and/or
 - Equitize cash resulting from domestic equity manager transitions.
3. The Program will not use futures for speculative purposes or to increase the equity exposure greater than the amount of the cash balances identified in policy number two above.
 4. The value of the S&P 500 Index futures contracts and/or SPDRs held in the program is limited to one percent of the market value of total assets.
 5. The Program will comply with the rules of the Commodity Futures Trading Commission (CFTC) and other regulatory agencies.
 6. Brokers will be selected for their quality of execution, overall quality of their derivative effort, quality and timeliness of their operation area, and creditworthiness of the clearing broker. A diversified group of brokers will be used to ensure overall quality of trade executions.
 7. The Chief Investment Officer is delegated authority to manage the Program internally and may use other investment personnel to implement the program.
 8. The Chief Investment Officer is delegated authority to trade appropriate securities for the Program and may ~~usedesignate~~ other investment personnel to ~~conduct trading~~act for him/her with regards to investments for the Program. The ~~graduated limitations of~~ daily ~~limits for approval of trade~~trading authority for S&P 500 Index futures contracts are designated below.

Chief Investment Officer	\$500 million <u>1 billion</u>
Director of Internal Equity	\$50 <u>250</u> million
Director of Fixed Income	\$50 <u>250</u> million
<u>Principal Investment Officer</u>	<u>\$200 million</u>
Investment Officer III	\$25 <u>150</u> million
Investment Officer II	\$40 <u>100</u> million
Investment Officer I	\$40 <u>25</u> million

9. Authorization letters which indicate who may transact business for the Program, including a copy of the most recent Investment Resolution, shall be initially sent to the broker at the time the account is established. Whenever there is a change in authorized personnel, CalSTRS will immediately notify all brokers in writing within twenty four (24) hours.
10. The Chief Investment Officer shall monitor the investment policies and report to the CalSTRS' Board quarterly or as otherwise requested.

Adopted January 13, 1999

Revised _____